Shadow Advisory Board

Cost control in the LGPS - A briefing note for members and employers

Summary

Under the new public service pension scheme framework, the costs of the pension schemes must be periodically assessed to ensure that the reforms are affordable and sustainable.

In the LGPS in England & Wales, there will be two mechanisms used to do this:

a) the employer cost cap (ECC) process as operated by HM Treasury, and
b) the future service cost (FSC) process as operated by the LGPS Scheme Advisory Board.

Both processes could lead to changes to the scheme design or to the level of members' contributions if the costs of the LGPS are shown to have moved sufficiently from the target.

The target cost for the FSC process is 19.5% as a total of employer and member contributions at a 2:1 ratio (13% relating to employers' contributions and 6.5% relating to members'). The proposed target cost for the ECC process is 14.6% of employer contributions alone.

The cost cap mechanisms are both mainly concerned with calculating the cost of providing benefits that have been accrued since the career average reforms took effect in April 2014. The total employer contributions targeted are therefore notional figures, and most employers will find they pay contributions that are different to these notional rates.

There are some differences between the mechanisms in how the requirement to make changes to the Scheme is triggered, but under either process, movement of 2% or more in either direction will require changes to be made to bring the Scheme cost back to the target.

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A member perspective

In the event that either of the processes demonstrate that the cost of the Scheme has increased or decreased to a point that a requirement for reform is triggered, the Scheme must be bought back to its target cost via one of the below two means:

- Changes to the design of members' benefits (for example, by changing the accrual rate or the normal pension age), or
- Changes to the member contribution rate.

The results of the cost control process could therefore lead to either, a) changes in the contributions which need to be paid in to the LGPS as part of Scheme membership, or b) to changes in the pension benefits eventually payable by the LGPS.

In the event that a design change cannot be agreed between the Government and the Scheme Advisory Board to bring the Scheme back to its target cost, an adjustment to the rate at which future benefits will accrue ('the accrual rate') must be made by DCLG.

An employer perspective

The figures calculated under the cost control processes will be broadly used to answer the question, "How much does the career average benefits structure cost across the LGPS in England & Wales?"

The results of the cost control processes are therefore highly unlikely to correlate with the contribution rates payable by individual employers. There are two main reasons for this:

- Local funding valuations are based on individual fund and employer experience and assumptions are made based on this experience. The cost control processes will be looking at Scheme experience nationally and consequentially making assumptions on this basis.
- Local funding valuations will include consideration of all the benefits payable by each fund and employer in their participation in the Scheme - including costs relating to the pre-April 2014 final salary benefits structure.

In the event that reforms to the Scheme do result from either of the processes, employers will also need to be aware of the crucial need to communicate with their employees to ensure that they understand the changes that will be made.

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1. Background

Key points: A crucial part of the new public service pension scheme framework is the requirement for schemes' costs to be periodically assessed against a cost control mechanism. In the LGPS in England & Wales, there will be two cost control mechanisms:

a) the employer cost cap (ECC) process as operated by HM Treasury, and
b) the future service cost (FSC) process as operated by the LGPS Scheme Advisory Board.

Both processes could lead to changes to the scheme design or to the level of members' contributions if the mechanisms demonstrate that the cost of the LGPS has moved sufficiently from the target.

In June 2010, the Chancellor of the Exchequer announced the formation of an Independent Public Service Pensions Commission to make recommendations on how public service pensions could be made more sustainable and affordable in the long term in a manner fair to both the public service workforce and the taxpayer.

The Commission, chaired by Lord Hutton of Furness, published its final report in March 2011 and this outlined a variety of proposals to reform public service pension schemes in order to achieve better sustainability and affordability. One of the proposals, recommendation 12, stated:

> *"The Government, on behalf of the taxpayer, should set out a fixed cost ceiling: the proportion of pensionable pay that they will contribute, on average, to employees' pensions over the long term. If this is exceeded then there should be a consultation process to bring costs back within the ceiling, with an automatic default change if agreement cannot be reached."*

In making this recommendation, the Commission has demonstrated that a crucial aspect of the package of reforms will be continually reviewing the public service pension schemes to ensure that the aims of sustainability and affordability are being met.

A new legislative framework for public service pension schemes was introduced by the Public Service Pensions Act 2013. In keeping with recommendation 12, this requires that public service pension schemes, including the Local Government Pension Scheme (LGPS), are regularly assessed against a cost control mechanism.

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Crucially, if an assessment under the cost control mechanism shows that the costs of the Scheme have moved sufficiently from the target cost, changes must be made to bring the Scheme cost back to the target.

This is known as the cost control process and, in the LGPS in England & Wales, there will be two mechanisms for assessing the cost of the Scheme:

- an Employer Cost Cap mechanism (ECC), operated by HM Treasury on advice from GAD which is the mechanism formally required by the Public Service Pensions Act 2013, and
- a Future Service Cost mechanism (FSC), operated by the LGPS Scheme Advisory Board, on advice from GAD and to the satisfaction of the Department for Communities and Local Government (DCLG).

Both processes will be undertaken in the LGPS every three years in line with the local triennial valuations that are undertaken by each pension fund to determine funding levels and the employer contributions payable in the coming period. The cost control mechanisms will first be used to assess the cost of the Scheme at the same time as the 2016 valuations, using data as at 31st March 2016.

Any changes to the Scheme's benefits structure or its employee contribution rates which arise from the 2016 cost control process will be effective from 1st April 2019.

Please note - All references within the remainder of this document to the Local Government Pension Scheme or the LGPS should be taken to mean the Local Government Pension Scheme in England & Wales.

2. The two mechanisms

Key points: There are two mechanisms because the ECC process has been partly established in order to demonstrate consistency between the public service pension schemes. Because of this, the LGPS Scheme Advisory Board FSC process has been set up to reflect the specifics of the LGPS experience in assessing the costs of the pension scheme reforms.

There will be a number of differences between the two processes, which will mean that the figures calculated through the ECC process won't always match the figures calculated through the FSC process.

In the event that the ECC is triggered but the FSC isn't, the ECC mechanism as operated by HM Treasury will take precedence.

There are two mechanisms for assessing the costs of the LGPS. The ECC process as operated by HMT will in some respects be standardised across all public service pension schemes to allow for some consistency of comparison between the schemes. The FSC process as operated by the Scheme Advisory Board has therefore been established to reflect the specifics of the LGPS.

Whilst both are actuarial estimations of how much it will cost to provide the benefits of the Scheme, there are certain differences between the calculations which will mean that each gives a different answer to the question, "How much does the career average benefits structure cost?".

For instance, the LGPS is alone amongst the public service pension schemes in offering a 50/50 section to its members. This section offers members the opportunity to broadly pay half the contributions and receive half the benefits. If there is a high take up of 50/50 section membership in the LGPS, that could cause an overall reduction in the total cost of the Scheme. However, the ECC process operated by HM Treasury will not take 50/50 membership into consideration in its calculations - instead it will assume that all members are in the full section of the Scheme. This could mean that different figures will emerge from the two processes because of the differing treatments of 50/50 members.

In addition, the processes may make different assumptions in respect of what will happen within the Scheme in the future. For example, when members come to retire they can choose to commute some of their pension and instead take this as a lump sum. The government currently plan that an assumption will be made across all public service pension schemes that on average 15% of the maximum a member can convert from annual pension is commuted to lump sum. In the event that the LGPS has different experience, the Scheme Advisory Board may choose to use a different assumption in its FSC calculations.

Crucially, in the event that the HM Treasury ECC process suggests that corrective action needs to be taken to bring the Scheme back to its target cost, but the Scheme Advisory Board FSC process suggests that no action needs to be taken, the HM Treasury process takes precedence and changes would need to be made to the Scheme.

3. The target costs

Key points: The target cost for the Scheme Advisory Board FSC process is 19.5% as a total of employer and member contributions at a 2:1 ratio (13% relating to employers' contributions and 6.5% relating to members'). The proposed target cost for the HM Treasury ECC process is 14.6% of employer contributions alone.

There are some differences between the mechanisms in how the requirement to make changes to the Scheme is triggered, but under either process, movement of 2% or more from the respective targets in either direction will require changes to be made to bring the Scheme cost back to either target.

The cost cap mechanisms are both only concerned with calculating the cost of providing benefits that have been accrued since the career average reforms took effect in April 2014. The total employer contributions targeted of 13% for the FSC and 14.6% for the ECC are therefore notional figures, and most employers will find they pay contributions that are different to these notional rates (for a number of reasons, as outlined further in the next section).

The target cost for the FSC process is 19.5% as a total of employer and member contributions at a 2:1 ratio (13% relating to employers' contributions and 6.5% relating to members'). The proposed target cost for the ECC process is 14.6% of employer contributions alone.

It is important to note that both processes are only designed to look at certain elements of the cost of the Scheme. Significantly, the mechanisms are being established to ensure that the new career average framework is sustainable and affordable, and therefore costs relating to LGPS Scheme membership accrued up to and including 31st March 2014 under the final salary structure will broadly not be considered in the calculations. That means that for employers, any contributions relating to prior to 31st March 2014 (ie. pre- April 2014 deficit contributions) will not be considered in the respective targets of 19.5% and 14.6% respectively. Further detail of the differences between the cost control mechanism and individual employer contribution rates as calculated during local funding valuations are outlined in the next section.

There are some differences between the mechanisms in how the requirement to make changes to the Scheme is triggered.

For the Scheme Advisory Board FSC process:

- A movement of between 0% and 1% from the target in either direction *may* result in agreed recommendations for action to move back to the target.
- A movement of between 1% and 2% from the target in either direction *should* result in agreed recommendations for action to move back to the target.
- A movement of 2% or more from the target in either direction *must* result in agreed recommendations for action to move back to the target.

By contrast, for the HM Treasury ECC mechanism, no corrective action will be required to move the Scheme back to the target unless there is a movement of 2% or more from the target in either direction.

4. The cost control mechanisms and local funding valuations

Key points: Whilst local funding valuations and the cost control processes will be undertaken in parallel every three years from 2016, there are significant differences in the purposes of these and the processes through which these are undertaken.

Local funding valuations include consideration of all benefits that will become payable by the Scheme in each fund, whereas the cost control processes will only be looking at the costs arising from the post-April 2014 career average benefits structure.

In addition, the calculations of local funding valuations and the assumptions as to future experience will be specific to each fund and to each employer, whereas the cost control processes will be looking at the membership across the LGPS, and will similarly be making assumptions at a Scheme-wide level.

For these reasons, the contribution rates of individual employers are not comparable with the results that will emerge from either of the cost control processes.

The cost control mechanisms and local funding valuations will both be undertaken every three years from 2016, and will be calculated using the data provided to each fund actuary to undertake local funding valuations. However, they are very different in process and the results of the cost control mechanisms should not be compared with individual fund and employer results as calculated through local funding valuations.

As mentioned above, a crucial difference is that the cost control processes have been implemented to answer the question, "What is the cost of the career average benefit structure implemented from April 2014?" By contrast, local funding valuations are undertaken to determine the contributions that need to be paid in by the participating employers to pay all the benefits payable to members. Local funding valuations and individual employer contributions therefore include consideration of benefits accrued by members prior to April 2014 under the final salary benefit structure.

In addition, whereas local funding valuations are undertaken by a locally appointed fund actuary, using assumptions about life expectancy, salary increases, etc, that are tailored to the experience of each pension fund, the cost control process calculations undertaken by GAD are based on national experience and so may differ from the assumptions used within each pension fund.

In determining individual employer contribution rates, fund actuaries also consider each organisation's membership profile. The cost control processes, however, look at the Scheme nationally ('the model fund') and this means that if, for instance, an organisation has a higher average age of LGPS members than the Scheme does across the board, that may mean there are differences between that employer's contribution rate and the average contribution rate calculated under either of the cost control processes.

For the above reasons, the contribution rates of individual employers are highly unlikely to correlate with the results that will emerge from either of the cost control processes.

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